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ABSTRACT

Critical to the success of current efforts to reform and restructure education and other community supports and services to improve the lives of children and their families is the way in which they are financed. This report of The Finance Project focuses on ways of using tax policies to help build strong local communities that can support families in raising their children. The report lays out the key roles of taxes in local economic development, considers types of tax incentives (deductions, credits, deferrals, exemptions and exclusions) and their intended effects, and principles for using tax incentives wisely. The report concludes with some proposals designed to illustrate how tax incentives can be used effectively to promote community building and development. (KB)

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TAX STRATEGIES FOR COMMUNITY ECONOMIC DEVELOPMENT

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THE FINANCE PROJECT

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TAX STRATEGIES FOR COMMUNITY ECONOMIC DEVELOPMENT

June 1998

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Prepared for
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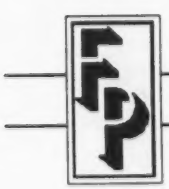

THE FINANCE PROJECT

ABOUT THE AUTHOR

Paul Pryde, Jr. is President of Capital Access Group, LLC, a financial advisory firm serving government and commercial clients that is located in Arlington, Virginia.

PREFACE

Across the country, there is mounting evidence of efforts to reform and restructure education and other community supports and services in order to improve the lives and future prospects of children and their families. Critical to the success of these initiatives is the way in which they are financed. How revenues are generated and how funds are channeled to schools, human service agencies, and community development initiatives influence what programs and services are available. It determines how they are provided and who benefits from them. Financing also affects how state and local officials define investment and program priorities, and it creates incentives that guide how educators, other service providers, and community volunteers do their jobs. For these reasons, financing fundamentally affects how responsive programs and institutions are to the needs of the people and communities they are in business to serve.

In recent years, several blue ribbon commissions and national task forces have presented ambitious prescriptions for reforming and restructuring the nation's education, health, and human service systems in order to improve outcomes for children. While some have argued that public financing and related structural and administrative issues are critical to efforts to foster children's healthy development and school success, none has been framed for the specific purpose of inventively reconceptualizing public financing. Indeed, many of the most thorough and thoughtful reports have called for an overlay of new funds, but have neglected to provide cogent analyses of effective financing strategies, the costs of converting to these approaches, and the potential beneficial outcomes that might accrue from addressing financing reform as an integral aspect of program reform.

In addition, the past several years have witnessed a burgeoning of experimental efforts by mayors and city managers, governors and state agency directors, legislators and council members, program managers and school officials to make government work better and more efficiently. They have been enhanced by the work of people outside of government, including foundation executives, business and labor leaders, community organizers, and academic scholars. Some are creating new ways to raise revenues, manage schools, deliver human services, and spur community economic development. Others are designing new public governance and budgeting systems. Still others are developing and testing new approaches to more directly involve citizens in setting public priorities and maintaining accountability for public expenditures. Taken together, these efforts suggest the nascent strands of new and improved public financing strategies.

Against this backdrop, a consortium of national foundations established The Finance Project to improve the effectiveness, efficiency, and equity of public financing for education and an array of other community supports and services for children and their families. The Finance Project is conducting an ambitious agenda of policy research and development activities, as well as policymaker forums and public education. The aim is to increase knowledge and strengthen the capability of governments at all levels to implement strategies for generating and investing public resources that more closely match public priorities, and more effectively support improved education and community systems.

As part of its work, The Finance Project produces a series of working papers on salient issues related to financing for education and other children's services. Some are developed by project staff; others are the products of efforts by outside researchers and analysts. Many are works in progress and will be revised and updated as new information becomes available. They reflect the views and interpretations of the authors. By making them available to a wider audience our intent is to stimulate new thinking and induce a variety of public jurisdictions, private organizations, and individuals to examine the ideas and findings they present and use them to advance their own efforts to improve public financing strategies.

This paper, *Tax Strategies for Community Economic Development*, represents a first step in The Finance Project's work exploring financing issues and strategies related to community building and development. It focuses on ways of using tax policies to help build strong local communities that can support families in raising their children. The paper lays out the key roles of taxes in local economic development, types of tax incentives and their intended effects, and principles for using tax incentives wisely. It concludes with some proposals designed to illustrate how tax incentives can be used effectively to promote community building and development. It is our hope that this paper helps lays a groundwork not only for further work by The Finance Project, but also for policy makers, public officials, advocates, and others seeking information and ideas on ways to improve the financing of supports and services for children, families, and communities.

The paper was prepared by Paul Pryde, Jr., who has researched, written, and consulted extensively on innovative financing—including the use of asset securitization—for community development and related investments. Helpful comments on a draft of this report were provided by Ira Barbell, Henry Coleman, Lowell Kalapa, and Rosalind Paaswell. Carol Cohen of The Finance Project staff managed this project and contributed to the final revisions to the paper.

Cheryl D. Hayes
Executive Director

INTRODUCTION

Families have the primary responsibility for raising their children to become capable adults. However, the communities they live in also contribute significantly to families' abilities to nurture their children. Healthy, economically vital communities offer business, employment, and entrepreneurship opportunities that create the income and wealth needed by families to purchase housing, food, clothing, and other goods and services for their children. Healthy local economies also create a tax base that enables the provision of education, public safety, transportation, social services, and other essential public investments affecting children and families. And they create formal and informal networks within and among businesses, community groups, neighborhood residents, and other individuals and organizations that have a stake in the economic and social fabric of the community.

While the national economy has grown well over the past few decades, especially in recent years, families in many communities do not have the benefit of thriving local economies. Some communities have been hurt by the changing structure of industrial production; others have lost industries to foreign competition. Families may reside in communities where there are not enough jobs, or where the jobs that exist do not pay enough to support a family. Workers may be unable to reach available jobs because of inadequate public transportation, or they may not have the skills needed for the jobs. Businesses and entrepreneurs in these communities may experience difficulty in gaining access to needed capital for investments.

Government at all levels can play a number of roles in fostering community economic development. These roles include creating an environment in which enterprises will locate, remain, and grow; aiding communities in responding to economic change; helping to distribute jobs, income, and wealth more fairly; and assisting in building the skills and capacities of local citizens. Although economic development activities may take a variety of forms—including investments in workforce development, support and technical assistance to business, targeted public investments in land and infrastructure, the provision of services to businesses and residents, and others—a key tool for promoting community economic development is tax policy.

THE ROLE OF TAXES IN ECONOMIC DEVELOPMENT

For good or ill, taxes often play a significant role in the way that labor and capital markets work, and therefore, in the pace, location, and scale of development. Put differently, who gets taxed, how they are taxed, and how much they are taxed can make a dramatic difference in the decisions that people make about whom to employ, where and in what to invest, whether and where to start a business, and where and for whom to work.

How Labor and Capital Markets Work—And Don't Work

Government does not determine who works where or for whom. Rather, workers generally obtain their jobs through a set of formal and informal arrangements generally referred to as the "labor market." Companies obtain financing through capital markets. As economists

Roger Vaughan and Peter Bearse put it,

> The purpose of a [labor] market is to send signals to the participants to indicate when they need to change their behavior and to indicate the direction of the appropriate change. The employer who fails to fill vacant slots is receiving a signal to raise wages. A job seeker who fails to find employment is receiving a signal either to seek elsewhere or to reduce expectations.[1]

In a similar fashion, capital markets provide signals to savers and borrowers. The saver who is receiving too low a return on an investment is being told to put the money elsewhere. The small business that is unable to secure financing is being told to provide a higher return.

When markets work well, the right signals are sent out and people respond according to the signals they receive. The firm that finds itself unable to attract more skilled workers reappraises its wage and salary structure, invests more in training the workers it has, or tries to make do with fewer employees. The frustrated job applicant goes back to school, changes careers, or reduces her salary demands. The saver takes money out of certificates of deposit and puts it in stocks. The small business agrees to increase the amount of interest or company equity offered in exchange for financing.

When capital and labor markets work well, these two production factors move from one use to another, from low-value to high-value uses, facilitating the creation of jobs, income, and wealth. Unfortunately, labor and capital markets do not function nearly as well in practice as they do in theory. Like "perfect" anything, perfect markets exist only on paper. "Market imperfections" – in the economist's neat phrase – result from three principal causes.

- Poor or costly information. The key to proper functioning of any market is information. In labor markets, employers and workers need to have adequate and accurate information in order to make correct decisions. If workers do not know where the jobs are, what skills or training the jobs require, and what wages they pay, they will have difficulty finding the jobs they need or want. Similarly, if employers do not know where skilled workers are and what levels of compensation they demand, they cannot make the right hiring and location decisions.

  Information is also key to making loans and investments – that is, to the way capital markets work. Investors and lenders tend not to make investments where information is scarce or inordinately expensive to obtain. The absence of good information at reasonable cost is a principal factor contributing to the inability or

[1] Roger J. Vaughan and Peter Bearse, "Federal Economic Development Programs: A Framework for Design and Evaluation," in Robert Friedman and William Schweke, eds., Expanding the Opportunity to Produce: Revitalizing the Economy Through New Enterprise Development, Corporation for Enterprise Development (Washington, D.C.), 1981, p. 314.

unwillingness of lenders and investors to provide funds to new firms. Identifying and evaluating new companies, especially small ones, is expensive. In addition, unfamiliarity with particular classes of firms, such as those owned by minority entrepreneurs or those located in economically distressed areas, can often lead to biased or erroneous interpretations of what information is available. Lenders, who work on thin profit margins anyway, are often not inclined to incur the additional cost of securing information on new and unfamiliar firms.

- Transaction and search costs. Finding a job costs time and money. So does finding workers. If search or transaction costs are extraordinarily high, they will increase the difficulty associated with finding and filling vacant positions. One of the reasons that informal employment networks work so well is that they are cheap. By contrast, for both workers and employers, formal methods of hiring are much more costly, involving countless hours spent on advertising, screening candidates, scheduling appointments, attending interviews, and completing forms.

  As bankers and investors know, doing deals can cost a lot of money. Since transaction costs do not rise proportionately with the size of the financing, lenders typically seek large, well-established borrowers, so as to minimize the impact of these costs on profits. One reason why commercial banks are reluctant to make many small-business loans is that the paperwork and additional work required by regulators make these loans much more expensive to make than, for example, consumer loans. Potential borrowers, too, can be deterred by transaction costs. The expense associated with putting together a sound legal structure or organizing the financial information needed to meet credit requirements can be prohibitive for the beginning entrepreneur.

- Risk and uncertainty. From the employer's point of view, hiring a new entry-level worker is an investment decision. Substantial wage and training costs must be incurred before the worker starts to produce more revenue than he or she costs. Since employers, like the rest of us, are risk-averse, employers will be reluctant to hire people whom they believe may fail to provide a decent return on investment. Similarly, workers will refuse employment if they believe that the chances of achieving certain long-term salary or advancement objectives are remote or highly problematic.

  For their part, investors and lenders want to make as much money as possible, while taking the lowest possible risk. If the return on a particular investment does not provide adequate compensation for risk, or if adequate loan guaranty or insurance arrangements are unavailable, investors and lenders will simply do what comes naturally – refuse to part with their money.

PRINCIPLES FOR TAX INCENTIVES IN COMMUNITY DEVELOPMENT POLICY

Because people intuitively know, as the old maxim goes, "You get less of what you tax and more of what you don't," policy makers at all levels of government face constant pressure and temptation to alter tax rules to achieve policy ends. Some of their ideas are good. Some are awful. A surprising number make no difference at all.

According to some observers, "economic war" has broken out among states and cities in recent years. As a report by the Corporation for Enterprise Development puts it,

> The new "civil war" resembles an escalating "arms race." Once all communities have followed suit and enacted a certain incentive, they must either maintain an inefficient subsidy or initiate a new round of battle by increasing the subsidy and gaining temporary benefits until a new standoff is reached...The spread [of incentives] appears to be largely the result of risk-averse behavior by development officers, combined with genuine ignorance among legislators. The result is a general feeling that incentives offered by other states have to be matched.[2]

The use of tax incentives as an instrument of policy has received scorching criticism from a number of analysts who argue that tax breaks are costly, inefficient, and ineffective. Truth be told, the evidence regarding the effectiveness of tax incentives in fostering economic growth is mixed, at best. While there is some evidence that tax incentives may influence business location decisions, it is often impossible to prove that business would not have made the same decision anyway. In these cases, the incentive is the worst of all policy tools. It is both expensive and useless.

Nevertheless, it is unlikely that development administrators and elected officials will give up using tax incentives to attract investment, recruit businesses, and reshape patterns of economic activity. This being the case, they can at least use them wisely.

Thus, we offer the following rules to keep in mind when tax incentives are being considered as an instrument of development policy. As always with generalizations, there are exceptions—and exclusions and exemptions.

- **Tax incentives are not the best tool for all purposes.** Policy mechanisms go in and out of fashion. Today, direct spending is out; indirect market interventions are in. Because they seem less intrusive than other forms of government intervention, tax incentives are especially fashionable today, when government is being admonished to do more "steering" and less "rowing." However, it is important to remember that sometimes absolute prohibitions are preferable to incentives in discouraging certain types of market behavior—for example, selling illegal securities.

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[2] Bidding for Business: Are Cities and States Selling Themselves Short?, William Schweke, Carl Kist, and Brian Dabson, Corporation for Enterprise Development, 1994, p. 37.

- **Tax incentives do cost money.** One of the neat things about tax incentives is that they don't seem to cost any money. It is true that tax breaks don't necessarily require appropriations, but they do have a cost: It's the money that the government would have collected in the absence of the incentives. Of course, there are certain types of incentives that really don't cost anything. But that simply means that nobody uses them, which, of course, means that they are useless. The more troubling—and much more common—problems are tax incentives that cost a lot and accomplish very little. Good examples are the child care tax credit and tuition tax credits that were proposed in last year's federal budget. The fact is that these small incentives will make very little difference in most people's lives. Nevertheless, because they are available, people will claim them.

- **Treasury officials design lousy incentives.** The principal job of the tax officials of any jurisdiction is to bring money in, not to give it away. As a result, despite their knowledge of the intricacies of tax policy, tax collectors may not do a good job of developing incentives to induce businesses, investors, or workers to make different decisions. Quite the contrary. They are likely to come up with ideas that meet two very simple tests: They are easy to administer, and they cost very little money. In short, they will design incentives to make their jobs—raising revenue and managing the tax system—easier.

  What the legislature giveth, the regulators taketh away. It is a well-established pattern with tax incentives. The Congress passes a credit, deduction, deferral, or exclusion. It is complicated, but possible to use. Then the Treasury Department issues regulations making the incentive hopelessly complex and expensive to use. Whether this is good or bad depends on where you stand on the issue. However, nobody who knows tax policy really celebrates victory until acceptable "regs" have been issued.

- **The higher the tax burden, the more valuable the incentive.** The most valuable tax incentive is one that reduces a heavy burden. The corollary, of course, is that the least valuable incentive is one that reduces an already low burden. For example, if taxes are 8% of a taxpayer's costs, an incentive which reduces this burden by, say, 20% will reduce total costs by 1.6%. Big deal! However, if taxes are 50% of the taxpayer's cost, reducing them by 20% will reduce overall costs by 10%. Now we're talking real money!

- **Tax incentives are easy to administer, but hard to target.** One of the nice things about tax incentives is that one doesn't need a large staff to consider proposals and hand out money. A taxpayer who qualifies for the incentive automatically gets it. If the law says you get a 10% tax break for investing in Elvis memorabilia, everyone who buys something at Graceland receives the 10% reduction in tax. There's no need to submit an application for funding to the Graceland program administration staff

and hope that there's still funding available. That's the good news. The bad news is that people who are not supposed to receive preferable tax treatment can also benefit. It is almost impossible to enact legislation that anticipates every possible transaction. Then, there are the tax lawyers. Paid handsomely, they can find or create loopholes in even the most carefully crafted legislation.

- **Tax incentives may be easy to enact, but they are impossible to repeal.** In this way, tax policy is not that much different from other laws. Once a statute is on the books, it's very difficult to remove it. However, the problem is compounded with tax laws. Because they are written in what seems to be ancient Greek, generally do not require annual appropriations, and often have powerful interest groups behind them, policy makers have great difficulty getting rid of them, no matter how much they cost.

- **Abuses will almost always occur.** Somebody will always use a tax incentive in ways not intended by the people who enacted it. The issue is whether the costs of abuses—lost revenue and unwanted market effects—outweigh the benefits. If not, then the incentive is probably worth preserving.

- **Tax incentives are only valuable to those who pay taxes.** This should be obvious. But, it's something that people enamored of elegant and indirect ways of influencing market behavior sometimes overlook. For example, lots of early enterprise zone legislation included provisions that reduced the income taxes of small firms located in designated neighborhoods. The theory was that this would make it attractive for entrepreneurs to start and grow their firms in depressed areas, thus making jobs available for residents. There was one small problem. Young, small firms generally don't make money in their early years, incur no tax liability, and have absolutely no use for tax relief. Oops!

- **The devil is in the details. Design is critical.** During discussions of whether a particular set of tax ideas will solve one problem or another, it is not unusual for somebody to proclaim, with absolute certainty, "Tax incentives don't work." This person may know what he or she is talking about (normally, it's a he), but generally not. Tax incentives are like most other things that human beings create. Sometimes they work as they're supposed to, sometimes they don't. It all depends on how well they're designed for their intended purposes. Because of the complexities in the tax system and of human behavior, putting together a tax package that works exactly—and only—as intended is difficult work. Yet, unless due care is taken in its design, all a new tax incentive will accomplish is to prove the loudmouth right.

- **Good design is tougher than you think.** One illustration will make the point. One of the good things about categorical grant programs is that, generally speaking, taking money from one source does not mean that you are automatically ineligible to

receive it from another. Not so with tax incentives. It's often the case that taxpayers who choose one type of preferential tax treatment automatically become ineligible for another. In this case, one incentive cancels another out. For example, an employer who claims employee-training expenses as a deduction may be ineligible for a brand-new employee-training tax credit enacted to encourage more private investment in "human capital." As a result, a well-intended, well-crafted piece of legislation could be rendered useless by some obscure provision of existing tax law. It happens all the time.

THE FOUR TYPES OF TAX INCENTIVES

Most tax incentives fall into four broad categories: deductions, credits, deferrals, and exemptions and exclusions.

Tax Deductions

A tax deduction reduces a taxpayer's tax bill by allowing qualifying expenditures to decrease the amount of income that is subject to tax. Its value—the amount by which tax payments are actually reduced—is equal to the taxpayer's tax rate times the amount of the deduction. For example, for someone in the 28% tax bracket, a $10,000 tax deduction reduces the tax bill by $2,800. This is how the home mortgage interests deduction works. People are allowed to reduce the amount of income on which tax is calculated by the amount of mortgage interest payments made during the year.

The following table compares a hypothetical taxpayer's income tax bill with and without the benefit of a $10,000 deduction.

	Without Deduction	With Deduction
Gross income	$100,000	$100,000
Deduction	-0-	(10,000)
Taxable income	100,000	90,000
Tax (28%)	(28,000)	(25,200)
Savings		2,800

Tax Credits

A tax credit is a dollar-for-dollar reduction in a taxpayer's tax bill. Unlike deductions, which are subtracted from income prior to determining tax liability, credits are directly subtracted from the tax liability. Because they have the same value to everybody, credits are often considered fairer than deductions. That is, deductions have more value to people in high tax brackets than to people in lower tax brackets, and thus favor the rich over the poor. For example, if you're in the 15% tax bracket, a $100 deduction reduces your taxes by $15; if you're in the 36% bracket, the same deduction reduces your taxes by $36. However, a 20% tax credit for a $100 expenditure would reduce every taxpayer's bill by $20.

Examples are the investment tax credit, research and development credits, and the earned income tax credit. The table below shows how a $10,000 tax incentive structured as a tax credit would affect the hypothetical taxpayer's tax bill.

	Without Credit	With Credit
Gross income	$100,000	$100,000
Taxable income	100,000	100,000
Tax (28%)	(28,000)	(28,000)
Credit	-0-	10,000
Net tax	(28,000)	(18,000)

Tax Deferrals

Deferrals allow taxpayers to postpone the payment of taxes until sometime in the future. In a way, they can be said to be interest-free loans from the government. That is, for a specified period of time, Uncle Sam—or a state or local jurisdiction—is allowing the taxpayer to keep money that would otherwise be paid out in taxes. At the end of the period, however, the money has to be given back, but without interest. The value of a deferral is essentially the present value of the savings realized by pushing the payment into the future. Put another way, it's the difference between borrowing at interest from a bank and borrowing at no interest from the government.

Exemptions And Exclusions From Income

Exemptions and exclusions allow taxpayers not to figure certain types of income into their tax computations at all. Interest on certain state or municipal bonds is an example. As a matter of arithmetic, exemptions and deductions work very much the same way. However, because of the intricate ways in which various tax provisions affect each other, they can produce very different results.

It should be pointed out that states, localities, and the federal government vary in the types of taxes they levy. This determines what types of incentives they can and should enact.

Local governments, for example, receive most of their revenue from property taxes and rarely levy income taxes. Thus, most of what they do must take the form of property tax relief.

State governments do levy income taxes but, generally, not property taxes. However, their income tax rates are generally much lower than federal rates. As a result, state income tax deductions are less valuable than the same deduction at the federal level, where the maximum rate is almost 40%.

The federal government levies an income tax, but no property taxes. Thus, its incentives are generally organized around the income tax.

THE FOUR TYPES OF DECISION MAKERS THAT TAX POLICY CAN INFLUENCE AND THE TAX INCENTIVES ORIENTED TO THEM

Credits, deductions, deferrals, and exemptions are typically used to influence the decisions of four groups of decision makers: investors, businesses, employers, and employees.

Investors

Tax incentives can be really useful in inducing investors and lenders to make investments that they ordinarily wouldn't find very attractive. They typically offer one of two benefits: either they allow taxpayers to finance an investment with money that would otherwise be paid out in taxes, or they allow the taxpayer to keep more of the money earned by that investment.

Investment Credits

Investment credits work by reducing the amount of the taxpayer's own money in the deal. By so doing, they effectively increase the investment's rate of return. Let's say you are entitled to a credit worth 30% of any investment in Elvis memorabilia. That means if you buy $10,000 worth of the stuff, you only use $7,000 of your own money to make the purchase. The remaining $3,000 is paid with found money—cash you would have given to the IRS. Let's say you sell the stuff you bought two years later for $15,000. Ordinarily, you would say you made a $5,000 profit on a $10,000 investment. However, with the incentive, you've made $5,000 profit on an investment of only $7,000, the amount of Elvis memorabilia actually purchased with your own money.

Perhaps the best known example of an investment credit is the Low-Income Housing Tax Credit (LIHTC). Originally enacted as part of the Tax Reform Act of 1986 and permanently extended and modified in 1992, it's designed to encourage investment by individuals and corporations in the construction or rehabilitation of affordable housing for low-income people. It provides an annual tax credit of 8% to 9% of the eligible investment for a period of 10 years. For building acquisitions and projects that are federally subsidized, a credit of 3% to 4% of the qualified investment is allowed. In essence, an investor who spends $100,000 on eligible costs could reduce his annual tax bill by $8,000 to $9,000 annually for 10 years. Essentially, Uncle Sam gives $80,000 to $90,000 of the amount invested back in installments.

Some states, such as California, also have supplemental LIHTC programs that provide additional credits.

Deferrals

Congress loves small and minority businesses. So, a few years ago, it enacted an incentive—the so-called "capital gains rollover" provision—that allows any corporate or individual taxpayer who sells stock in a publicly traded company to avoid payment of capital gains tax by investing the proceeds in a Specialized Small Business Investment Company (SSBIC). (An SSBIC is a SBA-regulated venture capital company organized for the purpose of financing minority-owned firms.) It works this way. Say you own $100,000 of Clorox Company stock

that you originally purchased for $50,000. Ordinarily, if you're in the 28% tax bracket and decide to sell the stock, you would have to pay $14,000 in taxes (0.28 x $50,000 in profit). However, if you decide to take the proceeds of the sale and invest it in the African-American Investment Company (a regulated SSBIC), you can avoid paying the tax. In this case, $14,000 of the investment you make is financed by Uncle Sam. There is one catch. When you sell the investment in African-American, then you have to pay the tax.

Exclusions and Exemptions

In 1993, Congress also enacted another incentive to promote small business investment. The "capital gains exclusion" provision allows an investor to exclude 50% of the gain on the sale of newly issued small business stock from income tax, provided the stock is held for five years. Only companies with less than $50 million in gross assets and earning most of their income principally from "active" sources—i.e., other than interest, royalties, and the like—are eligible. SSBICs, however, are expressly excluded from this limitation. Using our hypothetical SSBIC, let's say your $100,000 investment is worth $200,000 after 5 years. If you're in the 28% tax bracket, you would ordinarily have to pay $28,000 in taxes (0.28 x $100,000 in profit). However, if you can exclude 50% of the gain from your tax calculations, you only have to pay $14,000 in taxes. As a result, your after-tax profit goes up significantly.

In order to make investments in public facilities attractive, Congress has exempted the interest on certain debt issued by state and local governments from federal income taxation (though state and local governments may tax the interest). State and local governments are therefore able to finance projects, such as public infrastructure, schools, etc., at substantially lower interest rates than corporate borrowers pay. The reason is that the after-tax rate of return on a 7% tax-exempt bond can actually be higher than on a 9% taxable corporate bond. If you purchase a $100,000, 9% corporate bond, then you will receive $9,000 in interest payments annually. Assuming that you're in the 28% tax bracket, you will pay $2,520 in income taxes on the interest, leaving you with $6,480, for an after-tax yield of 6.48%. However, if you buy a 7% tax-exempt bond, you pay no tax on the interest, and both the before-tax and after-tax returns are the same—7%.

A new tax-exempt bond financing provision is included in the Empowerment Zone/Enterprise Community legislation enacted in 1994. It allows a qualifying business in either a designated Empowerment Zone or Enterprise Community to use tax-exempt "enterprise zone facility bonds" (EZ bonds) to provide up to $3,000,000 of financing for buildings or equipment. EZ bonds can finance manufacturing as well as commercial facilities, such as manufacturing plants, warehouses, wholesale or retail stores, and commercial office buildings.

Businesses

Business-oriented incentives reduce the cost of a firm's equipment, facilities, and inventory. By doing so, they are designed to make a particular region or community more attractive as a place to do business.

Equipment Deductions

Many states and the federal government offer incentives designed to reduce the effective cost of a firm's purchases of production machinery and equipment.

For example, the federal government allows firms to "expense" within the tax year (rather than depreciate over a number of years) up to $17,500 of the cost of equipment. In a recent extension of this provision, a qualifying business in an Empowerment Zone may take an immediate expensing deduction of up to $37,500 a year on purchases of equipment for in-zone use, instead of the $17,500 deduction allowable to taxpayers generally.

Let's say that ABC Manufacturing pays $17,500 for a piece of equipment with a useful life of 5 years. Ordinarily, it would deduct $3,500 each year as depreciation expense related to this piece of equipment. If the company is in the 25% tax bracket, then this deduction is worth $875 annually in tax savings over 5 years. However, if ABC can write the $17,500 off in one year—expense it—it receives an immediate tax savings of $4,375.

Property Tax Abatements

Many local governments give developers and firm's property tax relief for new buildings. One of the reasons that they do this is that property taxes are the only levies that some municipalities can impose—and thus are the only taxes they can give away. The other reason is that other municipalities have similar programs. Presumably, this makes property tax relief programs a competitive necessity.

Ironically, however, the very companies that demand property tax relief for their facilities are often the same ones that will threaten to pack up and move once local schools—which are often financed by property taxes—begin to deteriorate. The other problem with property tax relief programs is that they often reward decisions that would have been made anyway, making them very expensive and relatively useless. That is to say, the deferral of property taxes is rarely decisive in a location decision. Yet, the company will take the deferral because it's available. Who wouldn't?

One of the good things about property tax abatements is that they are generally quite straightforward. You put up an eligible facility, and the municipality agrees not to send you a tax bill for a specified number of years.

Sales Tax Exemptions

A number of states include sales tax exemptions as part of their enterprise zone programs. Depending on their particular structure, these exemptions allow companies to avoid taxes on inventory purchases and to avoid collecting taxes on sales made to their customers. What these exemptions have not done is create a lot of jobs. What they have accomplished is to make enterprise zones a good place for warehousing and wholesale outlets.

Employers

Incentives designed to induce employers to hire and train workers are invariably structured as credits—not deductions, deferrals, or exclusions. The reason is that employers can already deduct, as business expenses, most employee wage and training costs. Since deductions are

more valuable than deferrals (which require you to pay taxes eventually) and have pretty much the same effect as exclusions, credits are the only incentives left of value.

At the federal level, the two most prominent employer incentives are the Empowerment Zone Wage Tax Credit and the Work Opportunities Tax Credit.

The Empowerment Zone Wage Tax Credit (the EZ Wage Credit) was enacted as part of a group of tax and spending initiatives designed to address the "pervasive poverty, unemployment and general distress" of certain depressed areas. Under the provision, employers are entitled to reduce their federal tax bills by 20% of the first $15,000 in wages (up to $3,000) paid to eligible employees—generally, people who work and live in the Zone.

The EZ Wage Credit is almost a good idea. There are several problems with it. The first is that most wage credits appear to have little effect on hiring decisions. Thus, the government is bribing companies to do something that they would have done for nothing. The second problem is that the credit is a windfall. It does not just reward companies for hiring new workers. It also gives them a bonus for people who were already on the payroll. Essentially, companies are getting paid for being in the Zone when the boundaries were drawn. The final problem is that only big, established companies can really use the credit. Remember, the new, small companies—the ones that create most jobs—often have very little tax liability. Wage tax credits are among the incentives that are generally of little use to them.

The Work Opportunities Tax Credit, a revised (1996) version of the Targeted Jobs Tax Credit, provides a maximum $2,400 tax credit to employers who hire workers from specifically targeted "economically disadvantaged" groups.

Employees

Perhaps the most important employee-oriented tax incentive is the Earned Income Tax Credit. This credit essentially refunds payroll taxes to certain low-income workers. It is phased out as income rises.

Under current tax law, an employee may also deduct educational and training expenses when they are incurred in order to maintain or improve her skills in her current position. Expenses incurred for education/training that leads to a new profession or business are not deductible.

A FEW MODEST PROPOSALS

Some of the tax proposals designed to influence the decisions of employers, investors, firms, and workers actually work—a few, even, as intended. Many are simply wasteful or worthless, or both. Following are three simple principles which, if followed, can help avoid enactment of some of the worst ideas. Listed after these are my favorite tax ideas, which—of course—are absolutely faithful to these principles.

- Incentives should be market-correcting. Before deciding to enact a particular credit, deduction, deferral, or exemption, policy makers should have a good idea of what its market effects will be. At the very least, they need to assure themselves that the proposed policy will not make the problem worse.

- They should involve the minimum cost possible. Incentives should involve the least amount of cost needed to correct the problem. Too many incentives are unnecessarily generous, giving away public money for no good reason. For this reason, they should be carefully targeted—giving limited benefits to precisely specified groups of taxpayers in exchange for carefully prescribed actions.

- They should enhance economic equity. Many tax breaks benefit people who don't need them. They rob the poor and give to the rich. Sometimes this "reverse Robin Hoodism" is intentional. Sometimes it is an unintended consequence of well-intended but poorly designed policy. Tax incentives work by indirect means to help the poor—often by giving tax relief to people and companies with large tax liabilities. This is not necessarily bad. However, it is terribly important that policy makers satisfy themselves that benefits to the poor are simply indirect, not incidental.

Following are a set of proposals which I believe meet these tests and which would help promote business formation and growth in low-income areas. At the same time, they should encourage these businesses to hire low-income people. They could be enacted at either the state or federal level.

Give A Credit Or Deduction For Investments In Small And Minority Business

Business formation occurs where capital is plentiful. Almost none of the money, however, comes from government. Rather, most small firms receive their early seed capital from informal sources—friends, family members, and business associates. One way to encourage individual investors to provide risk capital to promising, young firms would be to make equity investments in these firms fully tax-deductible. To reduce the cost (and possible abuse) of this provision, it could be limited to businesses located in designated Empowerment Zones and Enterprise Communities. That is, a taxpayer who invests $10,000 in a new assembly plant in an eligible area would be entitled to a $10,000 tax deduction in that year. Upon sale of the asset, the taxpayer could be taxed (or not) at the normal capital gains rate. This provision was included in many early Enterprise Zone bills, and it deserves a trial under the current program. It could be paid for by reducing the value of employee wage credits available to Empowerment Zone firms. The incentive could also be structured as a tax credit.

Looked at from the investor's standpoint, the incentive, if structured as a deduction, would be more valuable as a federal, rather than state, provision. The reason, as mentioned earlier, is that federal marginal tax rates being higher than state rates, federal deductions are worth more than state tax deductions. As a credit, the incentive would be equally valuable as part of either federal or state tax systems.

From the point of view of the federal and state taxpayers—the people who will ultimately bear the incentive's cost—the incentive has both advantages and disadvantages. The biggest disadvantage is that, if improperly structured, the incentive could easily be used

in unintended and undesirable ways. For example, if not limited to external investors, a credit or deduction for small business investments could allow business owners to deduct the costs of investments that they would have made anyway.

The biggest advantage of such a provision is that a partial credit or deduction is far cheaper than direct government spending to achieve the same result. For example, using a 50% credit to induce a private investor to put $10,000 in a fledgling company is half as costly as investing the same amount with appropriated tax money.

Allow Qualified Lenders To Issue 501(c)(3) Bonds

Under current law, certain non-profit institutions can borrow using tax-exempt bonds to finance educational and other facilities. Allowing lenders (including cooperatives) who specialize in lending to businesses located in low-income areas to issue 501(c)(3) bonds would increase their access to private capital and improve their ability to meet the credit needs of job-creating entrepreneurs.

States could create the equivalent of 501(c)(3) bonds by providing a credit equaling, say, 30% of the interest earned on bonds issued to finance qualified lenders.

This provision could potentially accomplish two important objectives. First, it could make credit more affordable. That is to say, the amount a lender charges for a loan is largely a function of its "cost of funds." The lower the lender's cost of funds, the lower the interest rates it can charge for loans. By lowering a lender's cost of funds, the interest savings associated with 501(c)(3) bonds would allow them to extend loans to eligible residential and commercial borrowers at lower rates than are now feasible.

Second, it could make many community development finance institutions (CDFIs) more viable. Community development finance institutions are organizations that specialize in making loans in poor areas or to chronically underserved borrowers. Unfortunately, because many of their borrowers cannot afford to pay market rates for loans, CDFIs often operate on very narrow "spreads"—the margin between their cost of funds and the interest rates which they charge for loans. This, in turn, means that, unlike banks and other commercial lenders, their net interest income is often insufficient to cover their operating expenses. By enabling CDFIs to increase the margin between what they pay for money and what they charge for loans, 501(c)(3) bonds could increase their ability to become self-sustaining. This is especially important at a time when many states and localities find it increasingly difficult to finance community and economic development lending with public funds.

As with the small business investment incentive, widening the number of eligible issuers of 501(c)(3) bonds is not without public cost. The state or federal treasury forgoes taxes that would have been paid on the exempt interest income. However, it is certainly cheaper than appropriating money to accomplish the same purpose.

Provide A Credit For Contributions To Individual Development Accounts

Contributions to these accounts, which would be owned by individuals, could be used for specified purposes—training, education, starting a business, retirement, and employment-related expenses (such as day care and health care). Depending on their circumstances,

account owners would use their account balances to supplement wage income, purchase needed health care or other services (which might not be offered by the employer), or increase their employability by obtaining additional training or education. Anybody could contribute to any other person's account.

Accounts are all the rage these days—retirement accounts, education accounts, child care accounts, medical savings accounts. Combining what would be a lot of separate accounts into one "master account" has, in my judgement, three very important benefits.

The first benefit is simplicity. One account is just easier to keep track of than several different ones.

The second is flexibility. At different stages and times of their lives, people have different needs and preferences. An older person requires more health care and less education. A young person may want more child care and less retirement, and so on. A master account would allow the account owner to purchase as much of each type of benefit as needs and circumstances dictate.

The third is cost. If one has a $5,000 medical savings account, a $2,000 education account, and $3,000 retirement account, and all are financed largely with public money, he or she will have every incentive to spend the entire amount in the account. After all, any savings are simply lost or returned to the Treasury. However, a master account provides an incentive to economize on low-priority benefits, because the savings can be shifted towards higher-priority benefits. In such an environment, profligate spending would decline, and with it the cost of medical, education, and other similar services.

Conclusion

Ideally, these three sets of incentives would work together to increase the number of business births and expansions in low-income communities and the number of low-income people these businesses hire. It could work this way. The investment deduction would encourage savers to invest more of their money in young, job-creating firms, especially companies owned by people of color. With more capital, these firms would then borrow from specialized finance companies that use tax-exempt financing to obtain loanable funds. Fueled by needed financing, the firms would expand and would need to hire workers. Individual Development Accounts (IDAs) would enable low-income workers to be more competitive in seeking entry-level employment with this growing group of expanding firms. Workers would use their account balances to pay for job-related training (thus relieving employers of some of this cost). They could also pay for day care and health care costs which might not be fully covered, and supplement wage income which—at least initially—might be insufficient to live on. In short, the IDA would make work more attractive and sustainable for the employee, and hiring the worker less costly and risky for the employer. (It would also make the employee/employer relationship more of a contract among equals. The employee would pay his or her way from the outset, and would not be considered a "charity" case.) Finally, over time, job experience gained from entry-level employment (along with associated training) would enable workers to gain advancement within the firm or to find better employment elsewhere.

Knowing what we do about tax incentives—that is, how difficult they can be to design and how they often produce unintended consequences—cautions us that it might not happen this way at all. But this is one vision of what's possible. And at least that's a place to start.

ABOUT THE FINANCE PROJECT

The Finance Project is a national initiative to improve the effectiveness, efficiency, and equity of public- and private- sector financing for education, other children's services, and community building and development. With leadership and support from a consortium of private foundations, The Finance Project was established in 1994 as an independent, non-profit organization. It undertakes an ambitious array of policy research and development activities, policymaker forums and public education activities, as well as support and technical assistance activities.

The work of The Finance Project is aimed at increasing knowledge and strengthening the capability of communities, states, the federal government, and non-governmental initiatives to implement promising strategies for generating necessary fiscal resources and improving the return on investments in children and their families. Its activities are intended to:

- Examine the ways in which governments at all levels, and the private sector, finance education and other supports and services for children (age 0-18) and their families;
- Identify and highlight structural and regulatory barriers that impede the effectiveness of programs, institutions, and services, as well as other public investments, aimed at promoting children's growth and development;
- Outline the characteristics of financing strategies and related structural and administrative arrangements that support improvements in education, other children's services, and community building and development;
- Identify promising approaches for implementing these financing strategies at the federal, state, and local levels and assess their costs, benefits, and feasibility;
- Highlight the necessary steps and cost requirements of converting to new financing strategies; and
- Strengthen intellectual, technical, and political capability to initiate major long-term reform and restructuring of financing systems, as well as interim steps to overcome inefficiencies and inequities within current systems.

The Finance Project extends the work of many other organizations and blue-ribbon groups that have presented bold agendas for improving supports and services for children and families. It is creating the vision for a more rational approach to generating and investing resources in education, other supports and services for children and families, and communities. It is developing ideas, options, and policy tools to actively foster positive change through broad-based systemic reform, as well as through more incremental steps to improve the effectiveness, efficiency, and equity of current systems. It also provides support

and technical assistance to "reform ready" states, communities, and initiatives engaged in efforts to align their financing systems with their policy and program reform agendas.

For more information about The Finance Project and its specific activities, please contact:

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